

This letter determines that the synthetic lease described in the letter is a conditional sale for Illinois sales tax purposes. See 86 Ill. Adm. Code 2010(a). (This is a PLR).

March 21, 2002

Dear Xxxxx:

This Private Letter Ruling, issued pursuant to 2 Ill. Adm. Code 1200 (which can be found at <http://www.revenue.state.il.us/legalinformation/regs/part1200>), is in response to your letter of September 17, 2001 and the power of attorney for BBB and the other additional documentation received by our office on November 15, 2001, December 19, 2001, and February 5 and 27, 2002. Review of your request for a Private Letter Ruling disclosed that all information described in paragraphs 1 through 8 of subsection (b) of Section 1200.110 appears to be contained in your request. This Private Letter Ruling will bind the Department only with respect to COMPANY for the issue or issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that neither COMPANY nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

In your letter, you have stated and made inquiry as follows:

“On behalf of our client, we respectfully request the Illinois Department of Revenue ('the Department') to issue a private letter ruling pursuant to 2 Ill. Adm. Code Section 1200.110 with respect to the following factual situation.

***“General Information***

- “1. Enclosed please find an original Form IL-2848 Power of Attorney, authorizing FIRM to represent COMPANY, before the Department of Revenue.
- “2. This PLR is not requested with regard to hypothetical or alternative proposed transactions. The PLR is requested to determine the sales tax consequences of the actual business practices of COMPANY.
- “3. COMPANY is not currently engaged in litigation with the Department in regard to this or any other tax matter.
- “4. The Department has not previously ruled regarding this matter for COMPANY. Neither COMPANY nor FIRM has submitted the same or similar issues to the Department.
- “5. COMPANY requests that certain information be deleted from the PLR prior to dissemination to others. COMPANY requests that its name, address, location of

its headquarters, description of products being purchased and the name of its representative be deleted.

- “6. COMPANY knows of no authority contrary to the authorities referred to and cited below.
- “7. For business reasons, COMPANY may use one or more affiliated entities to enter into the transactions described herein. References to COMPANY may refer to one or more 100% related entities in accordance with COMPANY's business practices.

***“Statement of Material Fact***

“COMPANY is engaged in the business of developing and operating power generating facilities in Illinois and elsewhere. COMPANY has entered into a number of agreements to develop power generating facilities in conjunction with the Trust, a statutory trust representing various financing interests. In particular, COMPANY has planned to develop a power generating facility in conjunction with Trust to be located in CITY, Illinois (the 'Facility'). Pursuant to this plan, COMPANY and certain of its affiliates have entered into financing agreements (collectively, the 'Agreement') with Trust for the Facility.

“Specifically, COMPANY has formed a subsidiary, BBB, to handle the development of the Facility. Trust has been created as a special purpose entity by investors for the sole purpose of acting as the financing entity for this transaction. All of the beneficial interest in the Trust will be owned by the parties providing the financing (the 'Participants'). Neither the Trust nor the Participants are owned by COMPANY or its affiliates.

“For purposes of this transaction, COMPANY and Trust have agreed to a financing arrangement known as a 'synthetic lease.' A synthetic lease is a financing arrangement that, among other things, permits 'off balance sheet' financing for financial accounting purposes. This means that newly acquired assets are financed in a fashion whereby COMPANY will not be required to reflect the assets or underlying debt on COMPANY's balance sheet. This treatment is often desirable for financial accounting because of the more favorable metrics that can result from the relationship of revenue, assets and debt. Although synthetic leases are treated as off balance sheet transactions for financial accounting purposes (i.e., leases) the newly acquired assets are treated as purchases for US federal income tax purposes. Essentially, the lessee depreciates the asset, deducting its depreciation expense and interest expenses for tax purposes, but only deducts lease payment expense for financial accounting purposes. In addition, the various buy-out options included in a typical synthetic lease allow the lessee to capture any appreciation in an asset. From a lender's (i.e., the synthetic lessor's) perspective, the risk of loss associated with an asset is mitigated by the mandatory provisions that require a buy-out or transfer of the assets at the end of the lease. The terms of the synthetic lease must comport with the requirements of Statement of Financial Accounting Standards 13 ('SFAS 13'), which outlines the treatment of leasing transactions for financial accounting purposes, in order to get off balance sheet treatment.

“In order to obtain this financial statement treatment, Trust will be directed to purchase materials and equipment from various suppliers and then will resell (in the form of a

synthetic lease) the equipment under a resale certificate to BBB in CITY, Illinois. The synthetic lease will commence prior to the purchase of any materials and equipment, so that any materials and equipment purchased will become subject to the Agreement.

"The Agreements consist of two separate parts: (i) the synthetic lease (and ultimately sale) of tangible personal property and improvements to real property; and (ii) the ground lease of land. Each part is intended to qualify as or facilitate a synthetic lease under financial accounting standards. The ruling requested herein relates to the synthetic lease of the tangible personal property component of the Agreement, specifically, the power generating equipment and other related equipment (the 'Equipment'). Under the agreement, supplemental schedules will describe the types of property acquired by the Trust and sold to BBB (or an unrelated third party). These schedules will break out in detail costs in the following categories: equipment costs (other than pollution control equipment), pollution control equipment, engineering/construction costs (including tax paid by the contractor on any materials consumed in the construction process and real property improvements), fees and transaction costs, and financing costs.

"The Trust will be registered in Illinois as a reseller and will purchase the Equipment referred to above from various vendors under a resale certificate. COMPANY will inspect the materials and the Equipment for quality and appropriateness when it is delivered by the suppliers to the job site. COMPANY is also responsible for the undertaking and supervising the installation and testing of the Equipment and the development and construction of the Facility.

"Under the Agreement, BBB has an option to purchase the Facility, including the Equipment, from the Trust at or prior to the expiration of the approximately seven year term of the Agreement (the 'Agreement Period') for a specified lump-sum equal to the principal amount then owed to the Participants by the Trust for financing the acquisition of the Equipment and the construction of the Facility. At the end of the Agreement Period, BBB must either (i) renew the agreement, (ii) purchase the Facility, including the Equipment for an amount equal to the total outstanding unpaid principal amount owed for the Facility, including the Equipment (the 'Purchase Amount') or (iii) find, on behalf of Trust, a third-party buyer for the Facility, including the Equipment. The terms of the Agreement provide for the Facility and Equipment to be transferred to BBB, or a third-party buyer located by BBB on Trust's behalf, upon the expiration of the Agreement Period or any renewal thereof. The Facility and Equipment would not revert to Trust in either of these circumstances. If BBB does not purchase the Facility and Equipment outright and cannot find a third-party buyer to purchase the Facility and Equipment for the full Purchase Amount, BBB must pay a supplemental payment (in addition to the purchase price paid by the third-party buyer) equal to the lesser of (1) 83% of the outstanding loan balance, or (2) the difference between the price paid by the third-party buyer and the Purchase Amount. The Purchase Amount represents the unamortized principal amount based on the cost of the Facility and Equipment at the commencement of the Agreement. No attempt will be made under the terms of the Agreement to determine the actual fair market value of the Facility and Equipment at the end of the Agreement Period for purposes of calculating the purchase price. BBB may refinance the amounts owed at the end of the Agreement Period.

"For financial statement purposes, the Agreement will be classified as a 'synthetic lease.' However, for Illinois ROT purposes, the Agreement should be treated as a

conditional sale rather than a lease. The Agreement is not a lease under Illinois sales and use tax law because the Agreement mandates that BBB purchase the Facility and Equipment at the end of the Agreement Period (or any renewal thereof) or arrange for its sale to a third party. Under neither scenario will the Facility and Equipment revert back to the original financing entity. "Further, the price to be paid at the end of the Agreement Period will not be based on the fair market value of the Facility and Equipment at that time.

### ***"Ruling Request***

"COMPANY respectfully requests a binding PLR from the Department confirming that:

- "1. The terms of the Agreement entered into by COMPANY and Trust should be characterized as a conditional sale pursuant to 86 Ill. Adm. Code § 130.2010;
- "2. Since the Agreement should be characterized as a conditional sale, for purposes of the Equipment, sales tax should be paid on the principal amounts of the payments made under the agreement as they are received.

### ***"Relevant Authorities***

#### ***"Conditional Sale versus True Lease***

"Title 86 of Illinois Administrative Code Section 130.2010(a) ('Section 130.2010') is the regulatory authority that discusses the Illinois taxation of leases, including the classification of a lease as a conditional sale. Section 130.2010 states, in pertinent part, that conditional sale treatment will result:

...when the [leasing] transaction involves a lease with a dollar or other nominal option to purchase. Such a transaction is considered to be a conditional sale from the outset, and all of the receipts from the transaction are subject to Retailers' Occupation Tax.

"The Department has issued private letter rulings and general information letters discussing its interpretation and application of Section 130.2010 for purposes of classifying a lease as a conditional sale.

"Illinois Private Letter Ruling 97-0005 (February 26, 1997) ('PLR 97-0005') provides insight relating to the classification of a lease as a conditional sale for Illinois taxation purposes. In PLR 97-0005, a company entered into a 15-year lease containing a firm option to purchase a multi-use manufacturing/office facility. The company and the lessor, a financial institution that will provide the company with financing to acquire the facility, would enter into a 5-year lease agreement with payments, consisting of an interest component and possible small amortization of principal, due monthly. According to the lease agreement, the company at the end of the current lease term must either (a) renew the lease for an additional twelve month period, if there are any renewal periods remaining, (b) purchase all of the property for an amount equal to the unamortized principal (loan) amount, or (c) arrange for the sale of the property under the lease. Under scenario (c), if the proceeds received from such sale are less than the unamortized loan amount, the company will be required to make a final lease payment equal to the difference between the unamortized loan amount and the sale proceeds.

Based on the facts presented in PLR 97-0005, the Department held that the lease was a conditional sale. In arriving at its decision, the Department stated that conditional sales are usually characterized by a nominal purchase option at the close of the lease term, however, conditional sales may also be characterized by provisions requiring the lessee either to purchase the property at the end of the lease term or arrange for the sale of the property to a third party. The Department held that since the lessee at the end of the lease term must either purchase the leased property or arrange for its sale to a third- party, the lease is a conditional sale.

“General Information Letter 99-0169 (May 17, 1999) ('GIL 99-0169') also provides guidance relating to the taxation of leases in Illinois. According to GIL 99-0169, if a lessor/retailer is guaranteed that the leased item is going to be sold at the end of the lease term, then the lease agreement is generally considered a conditional sale at the outset of the transaction making all receipts subject to Retailers' Occupation Tax.

“Further, Private Letter Ruling 00-0003 (February 29, 2000) ('PLR 00-0003') states that if a lease contains a buyout provision, it must be at fair market value so that it is not recharacterized as a conditional sale. The Department in PLR 00-0003 concluded that the lease in question was a 'true lease' for sales tax purposes since the purchase option in the lease provides that the asset may be purchased by another person at prices that are equal to their projected fair market values, not at nominal purchase prices.

#### *“Retailers' Occupational Tax on Payments*

“Finance or interest charges are not considered part of the selling price for computing ROT liability under 86 Ill. Admin. Code 130.420(a). Furthermore, deferred payments, such as the principal amounts received by Trust under the Agreement, are not included in the seller's gross receipts until such payments are actually received by the seller under 86 Ill. Admin. Code 130.401(a).

#### **“Conclusions**

- “1. The Agreement should be treated as a conditional sale for Illinois Retailers' Occupational Tax ('ROT') purposes and not as a true lease. The Agreement does not meet the requirements for a true lease because the Facility and Equipment will be sold at a fixed price at the end of the Agreement. Furthermore, the payment due upon exercise of the buyout provision is not calculated as the fair market value of the Facility and Equipment at the time the buyout is executed.

“In the present situation, Trust is guaranteed that the Facility and Equipment will be sold at the end of the term of the Agreement. More specifically, the Agreement executed by Trust and BBB contains a provision which requires that at the end of the Agreement Period BBB either (1) renew the Agreement with the Participants; (2) purchase the Facility and Equipment for an established purchase price based on the outstanding principal amount; or (3) find a purchaser and pay the difference, if any in price (up to 83% of the outstanding balance), from what the purchaser is willing to pay for the Facility and Equipment and the purchase price it would be required to pay under the ~~first~~ second clause. These facts are substantially similar to the facts presented in PLR 97-0005 where the applicable agreement, which required the taxpayer to similarly renew its agreement, purchase the property for a specified price, or arrange for the sale of the property, was ruled to be deemed a conditional sale, and should be accorded the same

treatment. Furthermore, the purchase price of the Facility and Equipment in the present situation is: i) a fixed purchase price that will be known by the parties at the time the Agreement is executed; and ii) not based upon the estimated fair market value of the Facility and Equipment at the end of the Agreement Period. Since the Agreement guarantees the sale of the Facility and Equipment at a non-fair market value fixed price, the Agreement between Trust and BBB should be treated as a conditional sale for Illinois ROT purposes.

"2. Since the Agreement should be considered a conditional sale for Illinois ROT purposes, tax should be remitted only on the portion of each payment that represents a repayment of a principal amount.

### ***"Summary***

"The following summarizes COMPANY's conclusions with respect to the company's activity in the state of Illinois:

- "1. The terms of the Agreement are consistent with those of a conditional sale since the lessee is required to either purchase the Facility and Equipment at a predetermined price, which is not based upon a calculation of the fair market value of the Facility and Equipment at the end of the Agreement, or find an independent third party purchaser as describe in more detail above; and
- "2. For purposes of the Equipment that is subject to Illinois sales and use tax, as a result of the Agreement being treated as a conditional sale for Illinois taxation purposes, sales tax should be paid on the principal amounts as they are received.

"We respectfully request that the Department issue a ruling confirming that the Agreement described above will be treated as a conditional sale with respect to the Equipment for Illinois sales and use tax purposes and that ROT will be due on the principal payments for the Equipment as they are received.

"If the Department cannot conclude that the transfer of the Equipment pursuant to the Agreement qualifies as a conditional sale under the Department's regulations, I request that the Department contact me to determine what additional information is required or allow the taxpayer to rescind the ruling request.

"We will be happy to provide copies of the Agreement discussed in this ruling request and would welcome the opportunity to review the Agreement with you. Please contact me with any questions or to schedule a meeting to discuss any aspect of this ruling request. We appreciate your response on these issues. Thank you."

### **DEPARTMENT'S RESPONSE:**

Based upon your representations and the information you have provided, we believe that the Agreement between BBB and the Trust is a conditional sale rather than a true lease for Illinois Retailers' Occupation Tax and Use Tax purposes. See 86 Ill. Adm. Code 130.2010. This ruling is limited to the "Initial Vendor Equipment" disclosed under the Code "E" for original equipment and the Code "P" for pollution control equipment that are listed on the copy of Schedule 3 to Advance

Request (copy attached). In addition, this ruling is being issued with the understanding that none of the equipment referenced as the Initial Vendor Equipment will be incorporated into realty prior to completion of the sale between the Trust and BBB. The determination that this Agreement represents a conditional sale for this equipment is based upon the information provided in your letter ruling request that the Agreement creates an economic certainty that BBB or a third party arranged by BBB will purchase the equipment. According to the contract terms, BBB is not free to "walk away" from the lease at the end of the lease period.

For computing the amount of Retailers' Occupation Tax and Use Tax incurred on the conditional sale/ lease payments for the equipment described above, tax would be incurred as those payments are made and only on the principal portion of those payments (not on the interest or finance charges) as long as the books and records of Trust clearly reflect such interest or finance charges. See 86 Ill. Adm. Code 130.401(a) and 86 Ill. Adm. Code 130.420(a).

The facts upon which this ruling are based are subject to review by the Department during the course of any audit, investigation, or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

I hope this information is helpful. If you have questions regarding this Private Letter Ruling you may contact me at (217) 782-2844. If you have further questions related to the Illinois sales tax laws, please visit our website at [www.revenue.state.il.us](http://www.revenue.state.il.us) or contact the Department's Taxpayer Information Division at (217) 782-3336.

Very truly yours,

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Associate Counsel

TDC:msk  
Enc.